(1) 89- 1455

SUPREME COURT, U.S.
FILED
FEB 26 1990
JOSEPH F. SPANIOL, JR.
CLERK

In The Supreme Court of the United States

October Term, 1989

TRAGER, GLASS & COMPANY,
Petitioner,

vs.

JOSEPH M. NEWMYER, JOHN W. KWIATKOWSKI,
JOHN C. COLLINS and TOBIN R. COLLINS,
Respondents,

TRAGER, GLASS & COMPANY,
Petitioner,

vs.

EDWARD O'CONNELL,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

PETITION FOR WRIT OF CERTIORARI

NOREEN L. SLANK
Counsel for Petitioner
COLLINS, EINHORN & FARRELL, P.C.
4000 Town Center, Suite 909
Southfield, Michigan 48075
(313) 355-4141

ROMAN PRINTING CORPORATION, 550 W. FORT STREET
DETROIT, MICHIGAN 48226 (313) 962-0744

33 p/p

QUESTIONS PRESENTED

I.

GIVEN THE CONFLICT OF AUTHORITIES FROM THE CIRCUIT COURTS OF APPEALS, MUST HORIZONTAL COMMONALITY BE ESTABLISHED TO MEET THE *HOWEY* AND *FORMAN* "COMMON ENTERPRISE" COMPONENT OF THE TEST FOR DETERMINING WHETHER A TAX SHELTER INVESTMENT PROGRAM CONSTITUTES A "SECURITY", OR WILL VERTICAL COMMONALITY SUFFICE; IF HORIZONTAL COMMONALITY IS REQUIRED, DID THE SIXTH CIRCUIT COURT OF APPEALS PROPERLY APPLY THE TEST?

II.

IN MEETING THE *HOWEY* AND *FOREMAN* "REASONABLE EXPECTATION OF PROFITS" COMPONENT OF THE TEST FOR DETERMINING WHETHER A TAX SHELTER INVESTMENT PROGRAM CONSTITUTES A "SECURITY", MUST PROFIT AND NOT TAX ADVANTAGE HAVE BEEN THE PLAINTIFFS' *PRIMARY* MOTIVE?

III.

HAS THE *HOWEY* AND *FORMAN* REQUIREMENT OF PROFITS DERIVED "SOLELY FROM THE EFFORTS OF OTHERS" COMPONENT OF THE TEST FOR DETERMINING WHETHER A TAX SHELTER INVESTMENT PROGRAM CONSTITUTES A SECURITY BEEN SATISFIED IN THESE CASES, GIVEN THAT ALL CLOSING DOCUMENTS SHOW THE CRUCIAL ROLE OF PLAINTIFFS' *OWN* EFFORTS?

PARTIES TO THE PROCEEDINGS IN THE SIXTH CIRCUIT

The following parties were active in proceedings in the Sixth Circuit appeal which defendant Trager, Glass & Company seeks to bring before this court via Petition for Writ of Certiorari:

JOSEPH NEWMYER — Plaintiff

JOHN W. KWIATKOWSKI — Plaintiff

JOHN C. COLLINS and TOBIN R. COLLINS — Plaintiffs

EDWARD O'CONNELL — Plaintiff

TRAGER, GLASS & COMPANY[1] — Defendant

FRIEDMAN & SHAFTON, P.C. — Defendant

BOELTER, HOPT & GALE — Defendant

ROBERT V. YEO, JR. — Defendant

Other parties identified as defendants in these cases have either not filed Appearances in the Sixth Circuit, have not appeared in the District court, or are presently unrepresented by counsel in these proceedings and are subject to a bankruptcy stay.

---

[1] Pursuant to disclosure required under Rule 28.1, Trager, Glass & Company has no subsidiaries, affiliates or parent companies.

TABLE OF CONTENTS

	PAGE
QUESTIONS PRESENTED	i
PARTIES TO THE PROCEEDINGS	ii
TABLE OF AUTHORITIES	iv
OPINIONS BELOW	1
JURISDICTION	1
STATUTES INVOLVED	1
STATEMENT OF THE CASE	2
ARGUMENT	6
ADDENDUM	26
CONCLUSION	28

TABLE OF AUTHORITIES

CASES	PAGE
Ballard v. *Commissioner*, 56 T.C.M., 1988-426 . . . Dec.45,060(M)	25
Bausch v. *Philatelic Leasing*, 1990 W.L. 3613 (D. Md.)	9
Braniff Airways v. *LTC Corp.*, 479 F. Supp. 1279, 1286 (N.D. Texas, 1979)	24
Curran v. *Merrill, Lynch*, 622 F.2d 216 (6th Cir., 1980), *aff'd other grounds*, 456 U.S. 353; 102 S. Ct. 1825 (1982)	17
Dahl v. *English*, 578 F. Supp. 17 (N.D. Ill., 1983)	9
Deckebach v. *La Vida Carters*, 867 F.2d 278 (6th Cir., 1989)	17
Fabiano v. *Kessler*, No. C-2-84-1623 (S.D. Ohio, 1986)	9
Faircloth v. *Jackie Fine Arts*, 682 F. Supp. 837 (D. S.C. 1988)	9
First National Bank v. *Thoele*, Fed.Sec.L.Rptr. (CCH), ¶98,854 (1982)	15
Hocking v. *DuBois*, 885 F. 2d 1449 (9th Cir., 1989)	17
International Brotherhood of Teamsters v. *Daniel*, 439 U.S. 551, 559; 99 S. Ct. 790, 796 (1979)	7, 10–11, 13–14, 24–25
Joyce v. *Ritchie Tower Properties*, 417 F. Supp. 53 (N.D. Ill., 1976)	24

Kolibash v. *Sagittarius Recording*, 626 F. Supp. 1173 (S.D. Ohio, 1986) 9, 26

Lakshimkanth v. *Philatelic Leasing*, No. 3-83-0710 (D. Tenn. 1983) 9, 26

Malet v. *Riddell*, 383 U.S. 569; 86 S. Ct. 1030 (1966) 24

Marine Bank v. *Weaver*, 455 U.S. 551, 556; 102 S. Ct. 1220, 1223 (1982) 7, 14

Mordaunt v. *Incomco*, 469 U.S. 1115; 105 S. Ct. 801 (1985) 15, 17–18

Nakagawa v. *Ellis & Ellis*, Fed.Sec.L.Rptr. (CCH), ¶93,028 (1987) 9, 26

Randall v. *Loftsgaarden*, 478 U.S. 647, 657; 106 S. Ct. 3142, 3150 (1986)12 12

Reves v. *Ernst & Young*, ___ S. Ct. ___; 1990 WL 14015 (U.S.) 26, 27, 28

Rose v. *Commissioner*, 89-1 U.S.T.C., ¶9191 ... 25

Routh v. *Philatelic Leasing*, 1988 W.L. 161240 (E.D. Wash.); Blue Sky L.Rep. ¶72,707; Fed. Sec.L.Rep. ¶93,672 9

Schultz v. *Dain Corporation*, 568 F.2d 612, 615 (8th Cir., 1978) 26

S.E.C. v. *C.M. Joiner*, 320 U.S. 344, 351; 64 S. Ct. 120, 123 (1943) 7

S.E.C. v. *W.J. Howey*, 328 U.S. 293, 299; 66 S. Ct. 1100, 1103 (1946) 7, 10, 20, 24

Sunshine Kitchens v. *Alanthus*, 403 F. Supp. 719 (S.D. Fla., 1975)24 24

Tcherpenin v. *Knight*, 389 U.S. 332, 338; 88 S. Ct. 548, 554 (1967) 7

Union Planters National Bank of Memphis v. *Commercial Credit Business Loans*, 651 F.2d 1174 (6th Cir., 1981) *cert. denied*, 454 U.S. 1124, 102 S. Ct. 972, 71 L.Ed.2d 111 (1981) 16, 18

United Housing Foundation, Inc. v. *Forman*, 421 U.S. 837, 839; 95 S. Ct. 2051, 2059 (1975) 7, 10–13, 25

United States v. *Jones*, 712 F.2d 1316 (9th Cir., 1983) *cert. denied*, 434, 78 L.Ed. 2d 366 (1983) 17

U.S. v. *Philatelic Leasing*, 601 F. Supp. 1554, 1554 (S.D. N.Y. 1985) *aff'd* 794 F2d 781 (2nd Cir., 1986) 8

Wells v. *Jackie Fine Arts*, 1987 W.L. 140912 (S.D. Ohio) 9, 26

White v. *Philatelic Leasing*, 1987 W.L. 49640 (E.D. Tenn.) 9

STATUTES

26 U.S.C. §1221(1) 24

26 U.S.C. 6700, *et seq.* 8

MISCELLANEOUS

Arnold S. Jacobs, *Litigation and Practice Under 10b-5* 15

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

The Petitioner, Trager, Glass & Company, asks that a Writ of Certiorari issue to review the Judgment and Opinion of the United States District Court of Appeals for the Sixth Circuit.

OPINIONS BELOW

The decision defendant seeks to appeal is reported as *Newmyer* v *Philatelic Leasing*, 888 F.2d 385, Fed. Sec. L. Repr. ¶94, 767; RICO Bus. Disp. Guide 7357 (6th Cir., 1989).

The decision of the trial court, District Judge Barbara Hackett, is reported as *Newmyer* v *Philatelic Leasing*, 1987 W.L. 47363 (E. D. Mi.), Fed. Sec. L. Rep. ¶93,671.

JURISDICTION

The jurisdiction of this court is sought under 28 U.S.C. §1254(1).

Defendant Trager, Glass & Company seeks review from the Opinion of the United States Court of Appeals for the Sixth Circuit, decided and filed October 20, 1989, and from the Opinion denying rehearing entered by the same court on November 27, 1989.

STATUTES INVOLVED

The statutory definition of "security" under the Securities Exchange Act of 1934 and the virtually identical definition under the Security Act of 1933 are involved in this litigation, 15 U.S.C. §78c(a)(10), 15 U.S.C. §77(b)(1). See text set forth within Petitioner's Appendix as entries A-1 and A-2.

STATEMENT OF THE CASE

The subject matter jurisdiction of the federal court in these cases is premised on federal question jurisdiction pursuant to 28 U.S.C. §1331. Plaintiffs each allege violations of §27 of the Securities Exchange Act of 1934 [including 15 U.S.C. §78aa and 78j (b)], of §17a of the Securities Act of 1933 [15 U.S.C. §771], and of the Racketeer Influenced and Corrupt Organizations Act [18 U.S.C. §1962].

Defendant/Petitioner Trager, Glass & Company asks this Court to grant its Petition for Writ of Certiorari to reverse the decision of the Sixth Circuit Court of Appeals relative to the securities law issues presented by this case. Review of the RICO issues is not sought.

The Sixth Circuit panel (J. Merritt, J. Nelson, J. Celebrezze) determined that Plaintiffs' investment in Defendant Philatelic Leasing's tax shelter program constituted investment in a "security". The Sixth Circuit panel reversed the Opinion of Judge Barbara Hackett of the Eastern District of Michigan, Southern Division, which had granted Defendants' Motion to Dismiss the securities claims. Judge Hackett had ruled that the lease transaction was not a security because there was no "common enterprise", and because there was no reasonable expectation of profits to be derived from the efforts of others.

In 1979, Crailheath Ltd. obtained the rights to produce postage stamps for certain Scottish islands (Newmyer Complaint, ¶27, with each such allegation repeated in the Complaint of companion plaintiffs). Crailheath transferred these rights to Global International, which then produced the necessary masters at an approximate cost of $1,000.00 per master (*Id.*, ¶28). Stamp masters are photographic color separations used for printing postage stamps and/or related ancillary products (Hersch Affidavit, ¶3). In May of 1982, Global sold to Hambrose Stamps Ltd. the right to produce up to 9,711 different stamp masters with the provision that only 75,000 stamps could be produced from each master (Id., ¶29).

In June of 1982, Hambrose agreed to sell Philatelic up to 9,500 stamp masters (*Id.*, ¶31). Philatelic purchased 830 stamp masters (*Id.*, ¶32) and proceeded to organize a network of salesmen and, allegedly, distributors (*Id.*, ¶¶33–34).

In 1982, Philatelic Leasing's offering memorandum was prepared. That memorandum included a tax opinion authored by Defendant Friedman & Shaftan and a Trager Glass letter offering to assist lessees in the event of IRS challenge (*Id.*, ¶36). Plaintiffs claim that the offering memorandum failed to disclose certain facts, *Id.* at ¶37.

Defendant Trager Glass is a private corporation of certified public accountants (Affidavit of Trager, attached as Exhibit 3 to Docket entry 2, *Newmyer*). Trager Glass' only act with respect to the matters complained of was the preparation of the one-page letter which was included within Philatelic's 72-page offering memorandum. The memorandum, along with a 50-page tax opinion letter setting forth the tax consequences of investing in the shelter, was prepared by the law firm of Friedman & Shaftan. Trager Glass' letter made no representations regarding tax benefits from lease of the stamp masters. It made no representations regarding the prospects of profit from the leases. In its entirety it stated:

> Philatelic Leasing, Ltd.
> 950 Third Avenue
> New York, NY 10022
>
> Gentlemen:
>
> This is to confirm that in the event that the Internal Revenue Service or any tax agency challenges the tax structure of the transaction set forth in your Information Memorandum, dated September 1982, we have agreed to assist you in defending such challenge.
>
> Upon request by a lessee, we will assist their counsel and accountants if the Internal Revenue Service or any

> local tax agency challenges the tax structure of the transaction as set forth in the Information Memorandum and the lessee is unable to reach a satisfactory resolution at the initial audit level. Such assistance would include advice in connection with their appearances before the appellate division of the Internal Revenue Service. We would also be available to assist the lessee's counsel in defense before the U.S. District Court, U.S. Tax Court or the U.S. Court of Claims.
>
> Very truly yours,
>
> Trager, Glass & Company, CPA's, P.C.
> Lawrence Trager.

The uncontradicted Affidavit of Lawrence Trager of Trager Glass was submitted to the trial court. It attests to Trager Glass' noninvolvement in the preparation of the offering memorandum.

Each plaintiff claims that he was first exposed to the stamp master program via Defendant Robert Yeo, *Id.* ¶38. Yeo allegedly told plaintiffs that they would reap substantial tax benefits, that the shelter was a sound one, and that the lessees would be entering into a profitable business, *Id.* ¶39. Yeo gave plaintiffs copies of appraisals regarding the marketability of the stamps, *Id.* ¶40. He gave each plaintiff a copy of the Confidential Offering Memorandum, allegedly as proof that the shelter would pass IRS scrutiny, *Id.* ¶41. Allegedly as further proof of the ability to withstand IRS scrutiny, Yeo also gave each plaintiff a copy of a newsletter from Defendant Boelter, Hopt and Gale, *Id.* ¶44. Allegedly, the newsletter misadvised readers and made statements that were erroneous regarding the Philatelic program, *Id.* ¶45.

Each plaintiff leased stamp masters from Philatelic Leasing. Each of the plaintiffs were entitled to print and market stamps and ancillary products for personal profit, *Id.*, ¶48. A stamp master leased to one plaintiff was not leased to other plaintiffs (or anyone else); no plaintiff had any interest in

any stamp master which Philatelic Leasing leased to other persons, Hersch Affidavit, ¶3.

As part of their lease, plaintiffs each signed documents which specified their financial and managerial responsibilities in detail, Hersch Affidavit, ¶4. True copies of the respective plaintiffs' leases and security agreements, lessee questionnaire and the Confidential Information Memorandum were attached as exhibits to the Hersch Affidavit. No plaintiff contested the genuineness of these documents.

Each lease and security agreement provided for lease payments to Philatelic over a seven year term via a combination of cash and recourse notes for the first year, a partial recourse note for the second year, and non-recourse notes for the balance of the lease period, *Id.* at ¶5.

The Confidential Information Memorandum required that each lessee handle his own distribution and sale of stamps. See page 21:

> Distribution and sale of the stamps and ancillary products will be arranged solely by the lessee at his expense. For this purpose, a lessee may, for example, employ one or more distributors as his agent for the distribution and sale of the stamps and ancillary products, in which case the lessee will be responsible for the attendant fees and costs. Neither Hambrose nor Philatelic will designate or recommend distributors, but Philatelic will furnish a lessee, at his request, with a list of distributors known to the lessor.

Each of the plaintiffs' obligations with respect to stamp distribution and ancillary products was explained within the Confidential Information Memorandum, see page 11:

> Once [the stamps] are produced from the stamp master, the lessees must distribute them. Some lessees may elect to handle this task on their own. However, the vast majority of lessees are likely to select an established distribution company. There are a number of such companies

readily available and willing to handle the distribution of quality topical stamps. Philatelic cannot be a party to negotiations with these distributors.

Dell Philatelic Consultants Ltd., the distributor selected at least by Newmyer, John and Tobin Collins and Kwiatkowski (see Plaintiffs' Affidavits filed in the lower court), was not in any way affiliated or related to Philatelic, Hersch Affidavit, ¶9. Philatelic and Dell had no common officers, directors, employees or shareholders, office space was not shared, and Philatelic was not related to Dell in any way, *Id.* Philatelic did not recommend that plaintiffs enter into contracts with Dell and was not a party to plaintiffs' agreements with Dell, *Id.* The affidavit testimony of Hersch was never disputed by plaintiffs.

Each of the plaintiffs took tax deductions for the years 1980 through 1983. Each plaintiff received an IRS notice challenging these deductions, (*Newmyer* Complaint, ¶55).

ARGUMENT

CERTIORARI SHOULD BE GRANTED TO DETERMINE WHETHER A TAX SHELTER INVESTMENT PROGRAM CAN BE HELD A "SECURITY" SUBJECT TO REGULATION UNDER THE FEDERAL SECURITY ACTS. THE NATURE OF THE REQUIRED COMMON ENTERPRISE (HORIZONTAL OR VERTICAL) SHOULD BE RESOLVED BY THIS COURT AND PROFIT FROM THE ENTREPRENEURIAL OR MANAGERIAL EFFORTS OF OTHERS AS A REQUIRED PRIMARY MOTIVE SHOULD BE MORE CLEARLY ARTICULATED.

A. This court has established general guides which inform the definitional parameters of the concept of a "security".

The securities legislation was remedial in nature and the term "security" must therefore be "construed broadly to

effectuate [the Acts'] purpose", and a "narrow or restrictive" definition would be contrary to Congressional intent. *Tcherpenin* v. *Knight*, 389 U.S. 332, 338; 88 S. Ct. 548, 554 (1967). However, in enacting the securities laws, Congress " . . . did not intend to provide a broad federal remedy for all fraud", *Marine Bank* v. *Weaver*, 455 U.S. 551, 556; 102 S. Ct. 1220, 1223 (1982).

The term "security" " . . . embodies a flexible rather than a static principle, one that is capable of adaption to meet the countless and variable schemes devised by those who seek use of the money of others on the promise of profit", *S.E.C.* v. *W.J. Howey*, 328 U.S. 293, 299; 66 S. Ct. 1100, 1103 (1946). The reach of the term " . . . does not stop with the obvious and commonplace", *S.E.C.* v *C.M. Joiner*, 320 U.S. 344, 351; 64 S. Ct. 120, 123 (1943). "[F]orm should be disregarded for substance and the emphasis should be on economic reality", *Tcherpenin*, 389 U.S. 332, 336; 88 S. Ct. 553. Resolution should " . . . turn on the economic realities underlying a transaction, and not on the name appended thereto", *United Housing Foundation, Inc.* v *Forman*, 421 U.S. 837, 849; 95 S. Ct. 2051, 2059 (1975). However, the "name" assigned a transaction is not " . . . wholly irrelevant to the decision whether it is a security", *Forman*, *Id.*, at 850; 2059.

As to investment contract-type securities, courts must evaluate transactions according to the "commonly held understanding of an investment contract", *International Brotherhood of Teamsters* v *Daniel*, 439 U.S. 551, 559; 99 S. Ct. 790; 796 (1979). The securities laws should not be applied to a transaction absent " . . . characteristics that in our commercial world fall within the ordinary concept of a security", *Forman*, 421 U.S. 851; 95 S. Ct. 2060.

The general guides do little to aid resolution of this vexed question of what is, or is not, a "security" as applied to the particular transaction defendant Trager Glass seeks to bring before this court. Judge Knapp, in his opinion granting injuctive relief to the government against Philatelic Leasing and

the promoters of what was determined to be an abusive tax shelter under The Tax Equity and Fiscal Responsibility Act of 1982, 26 U.S.C. 6700 *et seq.*, detailed the nature of the present transaction:

> [W]e are concerned only with tax advantage investment programs ("shelters") which are created by the device of having the provider of the shelter lease supposedly productive assets — here, "stamp masters" — to taxpayers in circumstances where the lessor passes his investment tax credit (ITC) on to the taxpayer so that the latter can use it in reducing his tax liability. The lessor's ITC (which is passed on to the taxpayer) is based on its own cost in acquiring the asset. *U.S.* v *Philatelic Leasing*, 601 F. Supp. 1554, 1554 (S.D. N.Y., 1985) *aff'd* 794 F.2d 781 (2nd Cir., 1986)

The economic realities?

> By combining tax credits and deductions, the Philatelic 1982 shelter conferred, in tax shelter parlance, a "4 to 1 equivalent write-off". That is to say, a taxpayer would receive tax benefits four times greater than his actual cash outlay. *U.S.* v *Philatelic Leasing*, 794 F.2d 781, 782 (2nd Cir., 1986)

B. The Circuits are in conflict in interpreting this court's opinions defining an investment contract-type security, leading to unpredictability in outcome even as to identical or substantially similar transactions.

The opinions of this court offer specific guidance to the Circuits on the definition of an investment contract-type security. As will be seen, however, the Circuits are in conflict in interpreting this court's decisions. In fact, the Circuits have been in conflict on these issues for many years. The lease of "masters" (stamps, artworks, records . . .) litigation demonstrates what chaos rules.

The Sixth Circuit has informed the Michigan plaintiffs that, depending on factual developments the court apparently anticipates, they may very well have invested in securities when they leased their stamp masters in order to claim the 4–1 write-off. The Hawaii District Court in *Nakagawa* v *Ellis & Ellis*, Fed. Sec. L. Rptr. (CCH), ¶93,028 (1987) informed the similarly-situated Hawaiian plaintiffs that the Philatelic Leasing investment was *not* a security. This was also the conclusion of the Tennessee District courts which dismissed plaintiffs' claim in *Lakshmikanth* v *Philatelic Leasing*, No. 3-83-0710 (D. Tenn. 1983) and in *White* v *Philatelic Leasing*, 1987 W.L. 49640 (E.D. Tenn.) and of the Washington District Court in *Routh* v *Philatelic Leasing*, 1988 W.L. 161240 (E.D. Wash.); Blue Sky L. Rep. ¶72,707; Fed. Sec. L. Rep. ¶93,672. See also, *Bausch* v *Philatelic Leasing*, 1990 W.L. 3613 (D. Md.) reciting, see Westlaw page 3, that the Motion to Dismiss the securities fraud claims had been previously granted. Apparently the Michigan Sixth Circuit plaintiffs will be advantaged as compared to their peers in other jurisdictions.

Defendant Finesod, inactive in this litigation, is also a principal in an art masters lease tax shelter which bears great similarity to the Philatelic stamp masters program. In *Wells* v *Jackie Fine Arts*, 1987 W.L. 140912 (S.D. Ohio) and in *Faircloth* v *Jackie Fine Arts*, 682 F. Supp. 837 (D. S.C. 1988), the transactions were deemed *not* to be securities. In accord see *Dahl* v *English*, 578 F. Supp. 17 (N.D. Ill., 1983) [the sale of artworks in lithographic plate form not a security]. However, a lease of recording masters, again a tax shelter and again indistinguishable from the present case in terms of structure, was deemed a security in *Kolibash* v *Sagittarius Recording*, 626 F. Supp. 1173 (S.D. Ohio, 1986). The same type of master recording leases were found *not* to constitute securities in *Fabiano* v *Kessler*, No. C-2-84-1623 (S.D. Ohio, 1986).

C. This court's decisions in *Howey, Forman* and their progeny, require demonstration of horizontal commonality (involving a pooling of investments and a pro rata profit share) and profit as a primary motive. Certiorari should be granted to clearly articulate these standards.

The definitional parameters of an "investment contract" have been concisely stated by this court, first in *Howey, supra*, at 328 U.S. 301; 66 S. Ct. 1104, next reiterated in *Forman, supra*, at 421 U.S. 852; 95 S. Ct. 2060:

> We perceive no distinction, for present purposes, between an "investment contract" and an instrument commonly known as a "security". In either case, the basic test for distinguishing the transaction from other commercial dealings is:
>
> > "Whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others" *Howey*, 328 U.S. at 301.
>
> This test, in shorthand form, embodies the essential attributes that run through all of the Supreme Court decisions defining a security.

"The touchstone [of the *Howey* test] is the presence of an [1] investment in a [2] common venture [3] premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others", *Forman, supra*, at 421 U.S. 852; 95 S. Ct. 2060; *Daniels, supra*, at 439 U.S. 561; 99 S. Ct. 797.

In *Howey*, the defendant owned large tracts of citrus acreage and offered to sell narrow strips. Those who purchased the strips were to receive Warranty Deeds to the property. They were given the option, but were not required, to lease their land to a service company controlled and managed by the same people who controlled the defendant/seller. Eighty-five (85) percent of the buyers elected this option to cultivate

the land and harvest and market via the service contract. The small size of the plots rendered individual development economically unfeasible, *Howey, supra* at 328 U.S. 300; 66 S. Ct. 1103. "Such tracts gain utility as citrus groves only when cultivated and developed as component parts of a larger area", *Id.* In *Howey,* all the produce was pooled by the companies, who were "accountable only for an allocation of the net profit . . . ", *Id.* at 296; 1102. The investors gained or lost — together — and their enterprise was a common one.

The purchasers in *Howey* were persons residing "in distant localities who lack the equipment and experience requisite to the cultivation, harvesting and marketing of the citrus products", *Id.* at 300; 1103. Such persons " . . . are attracted solely by the prospects of a return on their investment", *Id.* The profits they so single-mindedly sought clearly derived solely from the efforts of others. The transaction was deemed a security.

The enterprise at issue in *Forman* was not one held reasonably calculated to produce profits. The question in *Forman* was whether the statutory definition of securities included buying shares entitling the purchaser to lease an apartment in a state-subsidized and supervised not-for-profit cooperative housing program. The majority answered the question, "No". In the process, the Supreme Court presented its most comprehensive analysis of an investment contract type security. The *Forman* court cited "common sense" and the lack of the usual features associated with stock ownership (e.g. voting rights, ability to be pledged, ability to appreciate in value) as suggesting that the persons who bought such "stock" must have lacked a profit motive, *Forman, supra,* at 421 U.S. 851; 95 S. Ct. 2060:

> In short, the inducement to purchase was solely to acquire subsidized low-cost living space; it was not to invest for profit.

In the absence of economic profit motive, i.e. where people are seeking housing, as in *Forman*, or seeking tax advantage, as in the present cases, security status will be denied.

Like the plaintiffs in the present case, favorable tax benefits were conferred upon the purchasers. The majority explained, *Forman* at 421 U.S. 855; 95 S. Ct. 2060:

> We know of no basis in law for the view that the payment of interest, with its consequent deductibility for tax purposes, constitutes income or profits. These tax benefits are nothing more than that which is available to any homeowner who pays interest on his mortgage.

In accord, see *Randall* v *Loftsgaarden*, 478 U.S. 647, 657; 106 S. Ct. 3142, 3150 (1986)[2].

The *Forman* court was resolute in its view that no profits were demonstrated, despite the fact that there was " . . . the possibility of net income derived from the leasing of . . . commercial facilities, professional offices and parking spaces and [the] leasing of community washing machines", *Id.* Such income was used to directly reduce tenant rental costs, but the *Forman* court saw such potential income as too inconsequential and too speculative to supply a proper profit motive. Security status was denied:

> Conceptually, one might readily argue that net income from the leasing of commercial and professional facilities is the kind of profit traditionally associated with a security investment. °°° But in the present sense this income — if indeed there is any — is far too speculative and insubstantial to bring the entire transaction within the Securities Acts. *Forman, supra*, at 421 U.S. 856; 95 S.Ct. 2062.

---

[2] *Randall* rejects the argument that the tax deductions petitioners were entitled to take by virtue of their partnership interests constituted income or profits. Tax deductions or tax credits "have no value in themselves" because the benefit arises only when such deductions are offset against income derived from other sources or when tax credits are used to reduce taxes otherwise payable on account of such income.

The "possibility" of rent reduction was not viewed as an expectation of profit in the sense found necessary in *Howey*, see *Forman*, 421 U.S. 857; 95 S. Ct. 2063.

As criticized by the dissenters in *Forman*, the majority held that only two forms of "profit" would be sufficient to supply status as a security: (1) the appreciation of capital or, (2) the participation in earnings, *Forman*, *supra*, at 421 U.S. 863; 95 S. Ct. 2066 (dissent). The majority explained its view; *Forman*, at 421 U.S. 852; 95 S. Ct. 2060:

> By profits, the court has meant either capital appreciation resulting from the development of the initial investment, as in *Joiner*, *supra*, (sale of oil leases conditioned on promoters' agreement to drill exploratory well), or a participation in earnings resulting from the use of investors' funds, as in *Tcherepnin* v *Knight*, *supra* (dividends on the investment based on savings and loan association's profits). In such cases the investor is "attracted solely by the prospects of a return" on his investment. *Howey*, *supra*, at 300.

The majority concluded there could be "no doubt" but that " . . . investors were attracted solely by the prospect of acquiring a place to live, and not by financial returns on their investment", *Forman*, *supra*, at 421 U.S. 853; 95 S. Ct. 2061.

This Court's effort to define a security, in part by reference to profits derived from the efforts of others, was continued in *International Brotherhood of Teamsters* v *Daniels*, 439 U.S. 551; 99 S. Ct. 790 (1979). *Daniels* reversed a Seventh Circuit opinion which had held that an employer-contribution pension fund constituted an "investment contract"-type "security" within the scope of the federal securities acts. As in *Forman*, this court again emphasized the lack of any dominant or primary profit motive, *Daniels*, *supra*, at 439 U.S. 560; 99 S. Ct. 797:

> [The employee] surrenders his labor as a whole, and in return receives a compensation package that is substantially devoid of aspects resembling a security. His decision

> to accept and retain covered employment may have only an attenuated relationship, if any, to perceived investment possibilities of a future pension. Looking at the economic realities, it seems clear that an employee is selling his labor primarily to obtain a livelihood, not making an investment.

Though the pension fund in *Daniels* depended in part on the managerial efforts of the Fund's managers, the greater share of the income came from new contributions. The transaction was beyond the scope of the federal securities statutes. This was so, in part, because profit could not be demonstrated given: (1) the lack of a primary profit motivation and (2) the speculative, insubstantial nature of any expectation of profit, *Daniels, Id.* at 439 U.S. 562, 99 S. Ct. 798:

> Even if it were proper to describe the benefits as a "profit" returned on some hypothetical investment by the employee, this profit would depend primarily on the employee's efforts to meet the vesting requirements, rather than on the fund's investment success. When viewed in light of the total compensation package an employee must receive in order to be eligible for pension benefits, it becomes clear that the possibility of participation in a plan's asset earnings "is far too speculative and insubstantial to bring the entire transaction within the Securities Acts", *Forman*, 421 U.S., at 856.

Marine Bank v *Weaver*, 455 U.S. 560; 102 S. Ct. 1220 (1982) sheds additional light on the definition of a security via the court's examination of the common enterprise prong. The transaction involved the Weavers, who purchased a $50,000 certificate of deposit from a bank, then pledged that certificate to the same bank to guarantee a loan to a company already $33,000 in debt to the bank on prior loans. The Weavers, in turn, were to receive 50% of the Company's net profits. The company went bankrupt soon after the Weavers guaranteed the loan and the bank then laid claim to the pledged certificate of deposit. The Weavers claimed the bank

withheld material information from them and they sought remedies under the securities statutes.

The Weavers' claim to security status for the transaction was rejected by this court. The unique nature of the agreement, negotiated one-on-one by the parties, and the fact that no public trading was involved was emphasized, *Marine Bank, supra*, at 455 U.S. 559-560; 102 S. Ct. 1225. Implied in this court's treatment was that there must be an investor-to-investor relationship [horizontal commonality] before a security will be said to exist. Mere investor-to-promoter relationships [vertical commonality] will fall short of establishing the common enterprise, see in accord on this interpretation of *Marine Bank*, *First National Bank* v *Thoele*, Fed. Sec. L. Rptr. (CCH), ¶98,854 (1982).

The three justices (Burger, White and Brennan) who dissented and urged that certiorari be granted in *Mordaunt* v *Incomco*, 469 U.S. 1115; 105 S. Ct. 801 (1985) believed that the issue of horizontal vs. vertical commonality, in connection with demonstrating a common enterprise, remained an open question. The various Courts of Appeals, now split on the question, have regarded the issue as a matter not yet settled by this court.

Arnold S. Jacobs, *Litigation and Practice Under Rule 10b-5*, §38.03(b)(iii) succinctly explains the differences between horizontal and vertical commonality:

> Under horizontal commonality, the plaintiff-investors must pool their investments, and courts usually also require that they share profits pro rata. Vertical commonality allows an investor's relationship either with the promoter or with the other investors to satisfy the "common venture" requirement; the investor therefore need not have any relationship with any other investor.

"Vertical commonality does not necessitate a pooling of investments, interdependence of the investors, or a pro rata sharing of profits. It follows that a plaintiff can more easily satisfy vertical commonality than horizontal commonality", Jacobs, *Id.*

Jacobs reports that the Fifth[3], Ninth[4], Tenth[5], and Eleventh[6] Circuits have endorsed vertical commonality. Horizontal commonality is endorsed by the Third[7], Sixth[8]

---

[3] *Long* v *Shultz Castle*, 881 F.2d 129, 140 (5th Cir., 1989) ["This court . . . has explicitly rejected the view that horizontal commonality is a prerequisite to establishing a common enterprise within the meaning of *Howey* and has focused instead on the 'vertical commonality' between the investors and the promoters."]; *SEC* v *Koscot*, 497 F.2d 473, 478-79 (5th Cir., 1984) ["The critical factor is not the similitude or coincidence of investor input, but rather the uniformity of impact of the promoter's decisions"]; *SEC* v *Continental Commodities*, 497 F.2d 516, 522 (5th Cir., 1974).

[4] *Hocking* v *Dubois*, (en banc) 885 F.2d 1449, 1459 (9th Cir., 1989), petition for cert. filed December 19, 1989, #89-1023. [With horizontal commonality, "The participants pool their assets; they give up any claim to profits or losses attributable to their particular investments in return for a pro rata share of the profits of the enterprise; and they make their collective fortunes dependent on the success of a single common enterprise", noting the Ninth Circuit accepts the sufficiency of " . . . either traditional horizontal commonality or, when no pooling among investors is present, a strict version of vertical commonality"]; *SEC* v *Glenn W. Turner*, 474 F.2d 476, 482 n.7 (9th Cir., 1973) cert den. 414 U.S. 821 (1974) ["A common enterprise is one in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties".]

[5] *McGill* v *American Land & Exploration*, 776 F.2d 923, 925 (10th Cir., 1985) ["The rigid horizontal commonality requirement . . . has never been a part of the law of this circuit"]; *Woodward* v *Terracore*, 574 F.2d 1023, 1025 (10th Cir., 1978).

[6] *Villeneuve* v *Advanced Business Concepts*, 698 F.2d 1121, 1124 (11th Cir., 1983).

[7] *Salcer* v *Merrill, Lynch, Pierce, Fenner and Smith*, 682 F.2d 459, 460 (3rd Cir., 1982) [In answering the question of whether a commodity account was a security, the court held *Howey* unsatisfied "because such an account is not an investment in a common enterprise" given that the investment "was not a part of a pooled group of funds"]; *Wasnowic* v *Chicago Bd of Trade*, 352 F. Supp. 1066, 1068 (M.D. Pa., 1972) aff'd 491 F.2d 752 (3rd Cir.) cert. denied 416 U.S. 994; 94 S. Ct. 2407 (1974).

[8] *Deckebach* v *LaVida Charters*, 867 F.2d 278, 281 (6th Cir., 1989) ["We specifically rejected the vertical commonality approach adopted by the Second, Fifth, and Ninth Circuits . . . The more liberal vertical commonality approach . . . effectively excises the common enterprise requirement from *Howey*. Without some link between multiple investors***would in trust mean the adoption of an expansive 'risk capital' approach that would effectively transform *Howey* into a two part, rather than a three part, test"; *Union Planters Nat'l Bank* v *Commercial Credit Business Loans*, 651 F.2d 1174, 1183 (6th Cir., 1981) cert. denied 454 U.S. 1124, 102 S. Ct. 972 (1981) ["A horizontal common enterprise . . . requires a heightened degree of affiliation. Horizontal commonality ties the fortunes of each investor in a pool of

and Seventh[9], *Id.* The Ninth Circuit operates under what that Court of Appeals, sitting en banc recently in *Hocking* v *DuBois*, 885 F. 2d 1449 (9th Cir., 1989) described as "a strict version of vertical commonality", *Id* at 1459. In the Ninth Circuit, it is not enough " . . . that the promoter has control of the investments . . . [the Ninth Circuit] also requires a correlation between the success of the promoter and that of the accounts themselves", *Mordaunt* 469 U.S. 1116; 105 S. Ct. 802. While the Sixth Circuit is firmly committed to horizontal commonality, see *Deckebach* v *LaVida Charters*, 867 F.2d 278 (6th Cir., 1989) and *Curran* v *Merrill, Lynch*, 622 F.2d 216 (6th Cir., 1980), aff'd other grounds, 456 U.S. 353, 102 S. Ct. 1825 (1982), the proper application of the test grows confused with the present opinion.

The three Justices writing in favor of granting Certiorari in *Mordaunt, supra*, a commodities futures contracts case, described the horizontal/vertical conflict existing in the Circuits in 1985:

> The importance of this conflict is not limited to the classification of discretionary commodities futures contracts. In related areas the lower courts are similarly divided as to whether *Howey* requires vertical or horizontal commonality. For example, the Ninth Circuit relied on its decision in this case in concluding that vertical commonality rendered a sale leaseback transaction a security. *United States* v *Jones*, 712 F.2d 1316 (9th Cir.,

---

investors to the success of the overall venture . . . . A requirement of horizontal commonality best comports with the language of *Howey*, because in a common enterprise all investors must share a common fortune]; *Curran* v *Merrill, Lynch, Pierce, Fenner and Smith*, 622 F.2d 216, 222 (6th Cir., 1980) aff'd other grounds 456 U.S. 353, 102 S. Ct. 1825 (1982).

[9] *Stenger* v *R.H. Love Galleries*, 741 F.2d 144, 146 (7th Cir., 1984) ["This Circuit has strictly adhered to a horizontal test of common enterprise, under which multiple investors must pool their investments and receive pro rata profits". This is in contrast to vertical commonality, in which "the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment"]; *Milnarik* v *M-S Commodities*, 457 F.2d 274, 278 (7th Cir., 1972) cert. denied 409 U.S. 887; 93 S. Ct. 113 (1972).

1983) cert. denied, 434, 78 L.Ed.2d 366 (1983). In contrast, the Sixth Circuit has relied on *Curran, supra,* in applying a horizontal commonality test to a loan participation agreement. *Union Planters National Bank of Memphis* v *Commercial Credit Business Loans,* 651 F. 2d 1174 (6th Cir., 1981) cert. denied, 454 U.S. 1124, 102 S. Ct. 972, 71 L.Ed.2d 111 (1981).

Mordaunt, supra, at 469 U.S. 1116; 105 S. Ct. 803.

Justice White, joined by Chief Justice Burger and by Justice Brennan, concluded that certiorari should be granted " . . . in light of the clear and significant split in the Circuits" on the question of horizontal vs. vertical commonality, *Mordaunt* at 1117; 302.

Since 1985, the split in the Circuits has grown more clear, and more significant, with hints (as in this case) that even horizontal commonality is now developing splinter theories. The necessity for clarity about what constitutes a "security" subject to federal securities law regulation grows more urgent in the present era. The Circuits and the regulatory agencies need this court's guidance. The present case provides the court with an excellent vehicle for articulating the proper standards for determining what must be demonstrated before a transaction can properly be characterized as a security.

D. Though correctly determining that horizontal rather than vertical commonality must apply, the Sixth Circuit erred in concluding that horizontal commonality could be demonstrated by reference to marketing efforts by defendant Dell which conceivably could have produced sales of the stamps or by Philatelic's commitment to take actions in support of the tax shelter which might benefit the investors as a group.

Plaintiffs each leased different stamp master printing plates from defendant Philatelic Leasing. The uncontradicted affidavit

of Hersch (Sixth Circuit Joint Appendix, p. 207) established that each plaintiff was entitled to print and market his stamps and ancillary products made from his stamps for his own profits and that none of the plaintiffs had any interest in the stamp masters which Philatelic leased to other persons.

The facts do not indicate a pooling of investors' funds. Failing this classic litmus test for demonstrating horizontal commonality, the panel reasoned primarily from the fact that three of the four plaintiffs had signed distribution contracts with Dell Philatelic Consultants (Opinion Denying Rehearing, 888 F.2d 399), i.e. "most" (888 F.2d 396) plaintiffs, and from plaintiffs' claims of conspiracy between Philatelic, Dell and Yeo. Per the panel, the Dell contracts and claims of concerted action, if demonstrated by plaintiffs, would be sufficient to supply the common enterprise requirement by demonstrating horizontal commonality. The court's analysis belies the undisputed factual record.

Dell was not related to Philatelic:

> Dell is not in any way affiliated with or related to Philatelic Leasing, Ltd. Dell and Philatelic Leasing, Ltd. have no common officers, directors, employees and shareholders; do not share office space; and are not related to each other in any way. Philatelic is not a party to the agreement between plaintiff and Dell. Philatelic did not recommend that plaintiff enter into his contract with Dell.

(Hersch Affidavit, ¶9; Sixth Circuit Joint Appendix, p. 212). The plaintiffs give differing accounts of their dealings with Dell, some claiming that Yeo recommended Dell, but plaintiffs

do not dispute Hersch's sworn statement that Philatelic did not recommend Dell.[10]

The Sixth Circuit concluded that: "If the plaintiffs in the instant cases can show a common enterprise among defendants Yeo, Philatelic and Dell, it would be a relatively simple matter for the plaintiffs to satisfy the horizontal commonality test", 888 F.2d 396. Assuming facts not in evidence, i.e. that the 1600 designs of stamps "were not more or less fungible", *Id.* at n.7, the panel saw " . . . no reason to suppose" that the marketability of the stamps varied from plaintiff to plaintiff. Thus:

> [I]t is entirely possible that if Dell had used the plaintiffs' money to advertise or otherwise promote these local stamps, developing a real market for them, all of the plaintiff investors would have benefited just as all of the investors in *Howey* stood to benefit from the service company's successful marketing of their oranges.

888 F.2d 396.

The effort to justify such a view by reference to *Howey* fails. In *Howey*, the service company and the owner of the citrus grove were "under direct common control and management", *Howey, supra*, 328 U.S. 295; 66 S. Ct. 1101. This contrasts with the present cases, given the undisputed fact that Philatelic and Dell were unrelated entities. Also, in *Howey*, all the produce was pooled by the two companies, who were then accountable to purchasers only for an allocation of the net profit, 328 U.S. 296; 66 S. Ct. 1102. Here, each lessee

---

[10] Newmyer states, see Newmyer Affidavit, ¶6, Sixth Circuit Joint Appendix, p. 382, that "Yeo recommended Dell". Collins agrees with Newmyer and contends that "Dell Philatelic was recommended by Robert Yeo", see Collins Affidavit, ¶5, Sixth Circuit Joint Appendix, p. 370.

Kwiatkowski gave a different version, see Kwiatkowski Affidavit, ¶6, Sixth Circuit Joint Appendix, p. 376, contending that Yeo gave him a list of distributing companies, including Dell.

O'Connell did not submit any Affidavit (or other) testimony which set forth his relationship (if any) with Dell.

would only gain from the sale of his own identifiable stamps and there was no pooling of profits.

The Sixth Circuit concluded that horizontal commonality is supportable in these cases even if the plaintiffs fail to prove their claims of concerted action. Citing such marketing successes as "pet rocks, op art, anything remotely connected with the late Mr. Elvis Presley", 888 F.2d 396, the panel looked to lease agreements and informed that if the stamps were successfully marketed Philatelic "stood to receive far larger amounts under the lease", *Id.* Demonstrating horizontal commonality was allowed to turn on whether: "The fortunes of Philatelic were directly linked to the success or failure that the stamps enjoyed in the retail marketplace", *Id.*

Apparently the court's proposed link between hypothetical marketing success and demonstrating horizontal commonality is whether Philatelic was "committed to action that might benefit the investors as a group", *Id.* The Sixth Circuit emphasized that Philatelic was committed to paying the bulk of its receipts over to Hambrose, which might in turn have enhanced the actual value of the masters and provided a revenue production history to aid defense of the legitimacy of the tax shelter. The panel rejected plaintiffs' arguments that the expectation of favorable tax benefits could supply the profit prong of the definition of security, yet in a strange twist allowed such thinking to stand as potentially determinative of the common enterprise analysis. The Sixth Circuit almost invited this court's review, 888 F.2d 397:

> Like the contention that horizontal commonality can be shown through Philatelic's commitment to defend the tax structure in court, the argument depends on the conclusion that a pooling of interests in the hope of securing tax benefits will satisfy the commonality requirement even though it cannot, by itself, satisfy the expectation of profits requirement. Where the Supreme Court would come out on this question — assuming the court agrees with us that horizontal commonality must be shown — we do not know.

The court felt it need not "come to grips" with the issue, given the claims of concerted activity between Dell, Philatelic and Yeo, but the issue was nevertheless treated extensively in the opinion, 888 F.2d 396-397.

While purporting to apply horizontal commonality, the panel in this case actually used a vertical test by finding a common enterprise would exist if each lessee's fortunes were interwoven and dependent upon the efforts of the promoter (Philatelic) and third parties (Dell and Yeo). Regardless of whether certain of the defendants acted in concert, horizontal commonality is not demonstrated here. Each plaintiff's profits were tied to how well each plaintiff's own stamps sold. That Philatelic's acts may have potential beneficial impact for all lessees, or that Dell's distribution efforts may have a similar potential impact, are not indicators of horizontal commonality. The Sixth Circuit recognized that horizontal commonality is the proper test to be applied, but erred in its application to the facts of this case.

E. The Sixth Circuit erred in concluding that "profits" derived from the efforts of others has been demonstrated in this case where it is clear that plaintiffs' primary purpose in leasing the stamp masters was not profit, but rather, tax advantage and where the plaintiffs' own activities propelled any profit-making effort.

On rehearing, the panel spoke of plaintiffs' single investment motive ["attracted solely"] but still found it necessary to ascribe dual motives to the plaintiffs' decision to lease the stamp masters: tax advantage and "true" profits in the sense of a return on investment:

> The investors in the present cases, as we must assume at this point, likewise had no desire to take personal possession of the stamp masters or use the masters themselves; unlike the plaintiffs in *Deckebach* [867 F.2d

> 278 (6th Cir., 1989)], *the plaintiffs here were attracted solely by the prospect of tax savings and a return on their investments*. [emphasis supplied]

Referring to Philatelic's offering memorandum and what the court characterized as its "glowing account of the popularity of stamp collecting", the panel writing in this case was not prepared to "rule out the possibility that Philatelic's investors hoped to realize 'profits' in the true sense of the term", 888 F.2d 395. As is clear from the Sixth Circuit's opinion, any claim to "true" profit motivation could not be maintained if plaintiffs were required to demonstrate that "true" profits, and not tax advantage, was their primary motive.

As the Magistrate aptly wrote in this case: "Plaintiffs all but concede that there was no reasonable expectation of profits (at least from the efforts of others) from the sale or marketing of their stamps °°°" (Magistrate's Opinion, p. 12). This was the only conclusion to be drawn, given the zeal with which plaintiffs advanced the view that their expected "profits," sufficient to confer security status, were the hoped-for tax benefits.

There can be no factual dispute but that profits were not the *primary* motive for these plaintiffs' investments. In briefing these cases in the Sixth Circuit plaintiffs reported they were adversely affected by the government's successful challenge to the Philatelic shelter: " . . . [B]ecause[plaintiffs] had invested in the Stamp Masters *primarily* as a tax shelter and secondarily as a way of making profits through the marketing of stamps by professionals" (Plaintiffs' Brief on Appeal to Sixth Circuit, p. 19). Recognizing that tax advantage was plaintiffs' primary motive, the Sixth Circuit should have felt compelled to reject the claim that these leases constituted securities. Profit as a primary motive is required if plaintiffs are to be able to demonstrate a reasonable expectation of profit.

Profit as the primary motive is the measure of reasonableness required by this court's prior rulings in securities cases.

See *Howey, supra*, at 328 U.S. 300; 66 S. Ct. 1103 where such status was allowed given that plaintiffs were "attracted solely by the prospects of a return on their investment"; *Forman, supra*, at 421 U.S. 852 relying on the *Howey* plaintiffs' sole profit motive and narrowly describing the two categories of profit sufficient to supply a reasonable expectation and assure that such claims will not be speculative or insubstantial; *Daniels, supra*, at 439 U.S. 560; 99 S. Ct. 797, looking to the economic realities of the pension fund and concluding that the employee's selling his labor "primarily to obtain a livelihood, not make [ ] an investment" disqualified the transaction from achieving security status.

In accord in requiring that profit motive be primary over other motives: *Joyce* v *Ritchie Tower Properties*, 417 F. Supp. 53 (N.D. Ill., 1976) [Sale of condominium property to be occupied by plaintiff as his residence does not constitute sale of a security as, "an expectation of 'profit' is not the motive when one's home is involved. . ." (55)]; *Sunshine Kitchens* v *Alanthus*, 403 F. Supp 719 (S.D. Fla., 1975) [Rejecting claimed *Forman*-type profits, where plaintiff's motive was the hope of favorable tax benefits and where such hope turned on showing a loss, not a profit]; *Braniff Airways* v *LTV Corp.*, 479 F. Supp. 1279, 1286 (N.D. Texas, 1979) [In dicta, given that the tax benefit "is significant and central to the plan" for investment, there is "significant doubt" about whether the *Howey* test can be met].

Requiring that an investor's profit motive be primary before a reasonable expectation of profits can exist sufficient to support security status is a result which is also directed by relevant tax law considerations. In *Malet* v *Riddell*, 383 U.S. 569; 86 S. Ct. 1030 (1966), the Supreme Court rejected the petitioner's claim to capital gain treatment for profits derived from the sale of real property. The statutory imperative that the property have been held "primarily for sale to customers in the ordinary course of [the taxpayer's] trade or business", 26 U.S.C. §1221(1), was interpreted to require such motive as "of first motivation" or "principally".

Correspondingly, in a tax case arising out of defendant Finesod's "Jackie Fine Arts" art masters tax shelter, the taxpayer's admission " . . . that tax considerations played a substantial role . . . " in the decision to purchase the art masters, disallowed the claim to any investment tax credits, *Rose* v *Commissioner*, 89-1 U.S.T.C., ¶9191. The Sixth Circuit panel in *Rose*, *Id.* approved the Tax Court's determination that the ITC must be disallowed since the acquisition of the art master was " . . . motivated primarily, if not exclusively, by tax considerations" and the taxpayers did not have "an actual and honest profit objective". In accord as to the "Jackie Fine Arts" leases, see *Ballard* v *Commissioner*, 56 T.C.M., 1988-426 . . . Dec.45, 060(M) [taxpayer denied interest and depreciation deductions, and ITC, as dealings between taxpayer and promoter indicated taxpayer was primarily motivated by the tax benefits to be gained rather than by profit].

The Sixth Circuit should not have been satisfied by the tenuous and hypothetical profit motive that it ascribed to the plaintiffs in this case. Acquiring profits by marketing the stamps was, at best, a very minimal motivator. Clearly, the primary motive for plaintiffs was tax avoidance. Given plaintiffs' meager marketing efforts, the possibility of marketing the stamps successfully was "far too speculative and insubstantial to bring the entire transaction within the Securities Acts", *Forman, supra*, at 421 U.S. 856; 95 S. Ct. 2062; *Daniels, supra*, at 439 U.S. 562; 99 S. Ct. 798. The Sixth Circuit erred by being satisfied with speculation about stamp sales "taking off". Plaintiffs' primary investment motive was tax avoidance/tax advantage and this is not sufficient to support identifying a transaction as a security.

The Sixth Circuit concluded " . . . that there cannot be an investment contract without some hope of profits *produced by the efforts of others* . . . ", 888 F.2d 395 (emphasis added), but then seemed to lose sight of the fact that it was the plaintiffs' own activities which propelled any profit-making

effort. This was made very clear by the Confidential Information Memorandum requiring that each plaintiff handle his own exploitation, distribution, and sale of stamps and ancillary products.

Simply because the lessees apparently delegated their authority to Dell, does not relieve them of the duties imposed upon them by the various closing documents, *Nakagawa, supra*, at 95,134 [a Philatelic case], citing *Schultz* v. *Dain Corporation*, 568 F.2d 612, 615 (8th Cir., 1978). The same conclusion was reached in *Lakshmikanth* v. *Philatelic, supra* ["It is apparent based on documents before the Court that in order for the plaintiff to derive profits from his investment in the Stamp Master Program he was required to perform numerous and substantial duties"]; *Wells, supra* [as to art masters program: "If any income was to be realized from plaintiff's sale of reproduction of his art masters, such profits would clearly depend on his own efforts"]; in accord, *Kolibash, supra* [as to record masters program].

Plaintiffs' individual efforts were crucial if the stamp master program was actually to produce profits. The Sixth Circuit erred in being satisfied that the facts put before them by Plaintiffs demonstrated profits derived from the entrepreneurial or managerial efforts *of others*. The efforts were plaintiffs' own.

ADDENDUM

On February 21, 1990, this court released its Opinion in *Reves* v. *Ernst & Young*, ___ S. Ct. ___; 1990 W.L. 14015 (U.S.). The case analyzes whether uncollateralized promissory notes issued by a Farmer's Cooperative in order to raise money to support its general business operations and payable on demand by the holder constituted securities under the Securities Exchange Act of 1934. The majority concluded that the "note" category of instruments described as securities at §3(a)(1) of the Act applied to the transaction.

The *Howey* test for "investment contract" securities was not before the court and was viewed as "irrelevant to the issue," *Reves*, n.4. However, *Reves* offers general guidance for determining whether or not a transaction is a security. A four-part test is articulated:

> First, we examine the transaction to assess the motivation that would permit a reasonable seller and buyer to enter into it. If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments *and the buyer is interested primarily in the profit the note is expected to generate*, the instrument is likely to be a "security". . . [Emphasis added]

On the other hand, if exchanged to facilitate some other "commercial or consumer purpose", the instrument is less sensibly described as a security," *Id.* Thus, this court accepted that profit as a *primary* motive is crucial to the definition of a security. Significantly, at n.4, this court also reiterated the *Howey* definition of profit applicable to investment contracts, restricting profits to capital appreciation or participation in earnings.

Secondly, the "plan of distribution" is to be examined to determine whether there is "common trading for speculation or investment", *Reves*. As is clear from the offering materials, the stamp masters were being marketed and distributed primarily as a tax shelter, requiring the investor's own entrepreneurial effort if any profit was to be realized from sales.

Thirdly, the "reasonable expectations of the investing public" are critical, *Id.* The plaintiffs have been rather forthright in stating their expectations: they invested in the shelter primarily for its tax benefits and only secondarily for what marketing success might result. The investing public, reading the offering literature, would clearly have similarly understood that tax advantage was fueling the program.

Finally, the existence of another regulatory scheme which renders securities regulation unnecessary suggests that a

transaction is not a security, *Reves*. In this case, the United States prosecuted the principals involved with Philatelic. The operation was shut down pursuant to a regulatory effort under the Tax Equity and Fiscal Responsibility Act, 26 U.S.C. 6700 *et seq.*

As Justice Stevens wrote in concurrence in *Reves*, "there is a strong interest in enabling" those affected by securities issues to predict the legal consequences of their proposed actions. Defendant asks that this court continue the effort to create predictability on this crucial topic and to accomplish for the "investment contract" security category what *Reves* accomplishes for the "note" category.

CONCLUSION

The nature of the common enterprise required to support the existence of a security is an issue which has divided the Courts of Appeals for more than a decade. Even where the lower courts purportedly adopt identical interpretations of this Court's decisions, in application, and as this case demonstrates, the results are unpredictable. This is not tolerable, particularly in times like the present when securities regulation performs crucial public policy functions. Further, the Sixth Circuit's analysis of the required profit motive conflicts with prior decisions of this Court. The Writ of Certoriari should be granted.

Respectfully submitted,
COLLINS, EINHORN & FARRELL, P.C.

By: _____

NOREEN L. SLANK
Counsel for Petitioner
4000 Town Center, Suite 909
Southfield, Michigan 48075
(313) 355-4141

Dated: February 21, 1990